

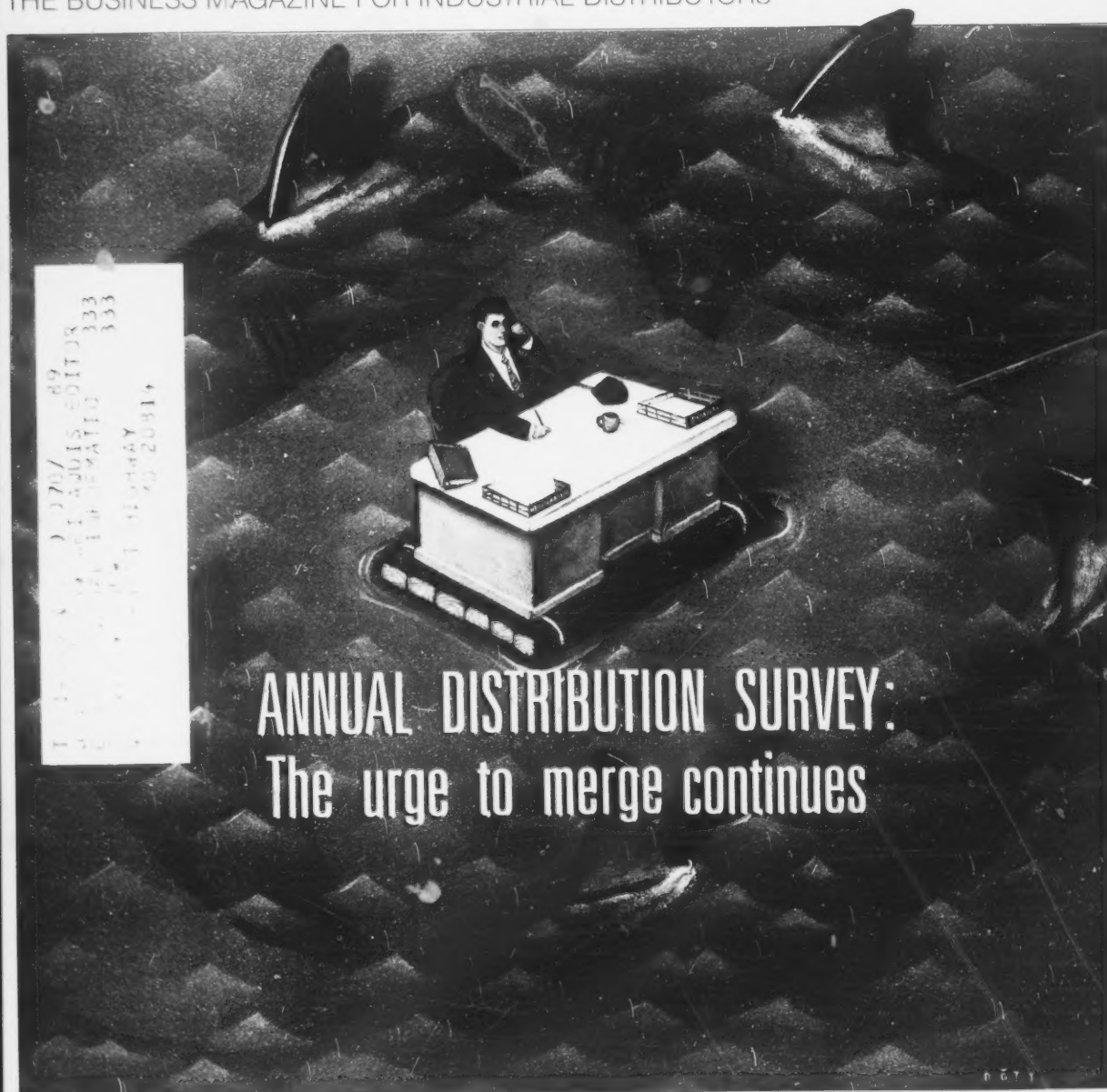
JULY 1989
A CAHNSERS PUBLICATION

Industrial Distribution

THE BUSINESS MAGAZINE FOR INDUSTRIAL DISTRIBUTORS


SPECIAL:

Facility Maintenance Buyer's Guide



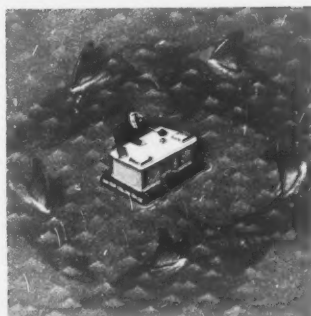
Industrial Distribution

THE BUSINESS MAGAZINE FOR INDUSTRIAL DISTRIBUTORS

VOL. 78, NO. 7

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Cover art by Curt Doty

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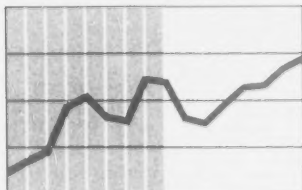
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Amid rising sales and slender margins

The Urge to Merge Continues



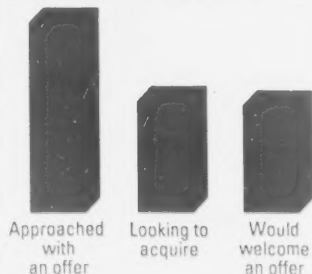
By John G.F. Bonnanzio,
Associate Editor

During 1988 the sun shined brightly upon the faces of industrial distributors. In results garnered from *ID's 43rd Annual Survey of Distributor Operations*, the nation's suppliers of MRO products enjoyed 1988. Rallied by rising exports, manufacturing's 6% growth in production was enough to help distributors drive home a 9% increase in sales. Better yet, improvements were also made to the industry's bottom line.

Nonetheless, industry-wide consolidation seems to have accelerated, spurred in part by concerns that profit margins will become increasingly difficult to maintain in the years ahead. But for the time, dis-

tributors held most operating expenses steady in 1988, as return on investment climbed from 10 to 11%.

AN APPETITE FOR MERGERS



Source: Industrial Distribution

Half of all distributors with \$5+ million in sales were baited for a buyout, feeding the acquisition frenzy.

Although distribution's 1988 selling season was helped by manufacturing's performance, some businesses barely made it to the batter's box. Depending upon factors such as geography, product mix and sales size, the *Survey* demonstrates that distributors should focus on improving productivity rather than relying on potentially revitalized smokestack industries for enhancing profitability.

With more than 400 distributors supplying statistical data, evidence profiles an industry in transition. Mergers and acquisitions, regional shifts in manufacturing, and profitability by product specialty illustrate that bigger is generally better, automation of management routines is a must, and perhaps most threatening, consolidation is a reality that will not soon disappear.

First, the good news

The most important measure in business, suggest accountants, is not how much you earn, but rather how much you keep. During 1988, industrial distributors got to keep more than they did the year before.

With median sales of \$1.9 million in 1987 (see "Medians & averages" on p.), distributors pushed up performance 8.8% to \$2.1 million. This increase closely matched the Industrial Distribution Assn's. National Sales Index which climbed 10%; the American Supply & Machinery Manufacturers' Assn's. New Order Index (+7.4%); nonelectrical machinery production (+12%), and; metalworking machinery production (+10%).

On a state by state basis, distributor sales were far more inconsistent. For example, while median sales increased nearly 30% in the West (the nation's strongest region), the Northeast lost ground with declining sales of 6.5%. But geography was no guarantee of suc-

cess. While California and Washington enjoyed the fruits of a soaring aerospace industry, sales for one Golden State distributor disintegrated by 75%, while a handful of suppliers in New York reported sales surpassing the 50% mark.

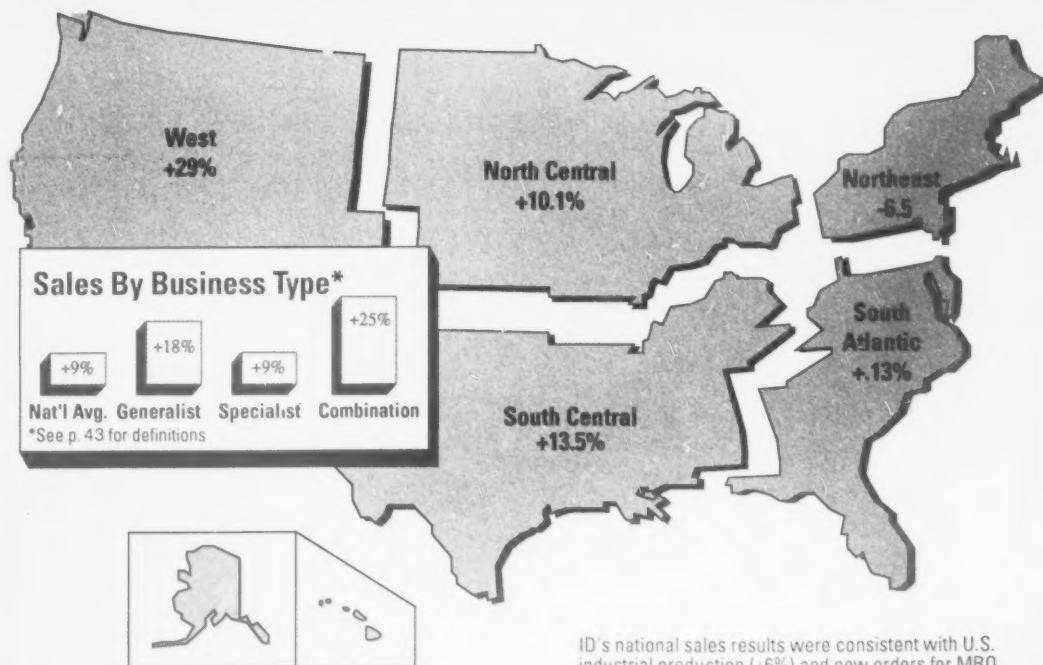
Another big winner was the South Central region with every state except Texas finishing 1988 ahead. As OPEC prices stiffened, rig counts inched upward in Louisiana, Oklahoma and the Gulf. This, combined with greater auto-related manufacturing in Kentucky and Tennessee helped to send sales in the region up 13.5% for the year.

Although rain failed to visit many mid-western farmers during 1988, unexpectedly, higher sales showered distributors in Kansas, Iowa and Nebraska. In the Great Lakes states, distributors expected a strong year of sales, and seemed to get it. Overall, the North Central Region finished 1988 ahead of 1987 by 10.1%. With its pervasive

manufacturing base, the Midwest has probably been the country's greatest beneficiary of the weakened dollar abroad and surging export trade at home. Since 1985, personal spending in the region has caught up with the rest of the nation—further evidence that for the time being, manufacturing is back.

Perhaps the biggest disappointment in this year's *Survey* (as well as the largest surprise), were results from the South Atlantic region. Although the Dept. of Commerce predicts that the South's population and employment growth will outpace the rest of the nation by 50% through the next 10 years, its trickle-down effect seems to have temporarily stalled sales of MRO products. This is not to suggest that the region is "recessed." Far from it. On the heels of a banner year in 1987 (sales were up over 30%), the South Atlantic may simply have hit its stride, with steadier growth likely in the future.

1988 SALES BY REGION (% change 1988/87)



ID's national sales results were consistent with U.S. industrial production (+6%) and new orders for MRO manufacturers (+7.4%).

Source: Industrial Distribution

SALES & PROFITS

Return on net worth improves

How profitable is industrial distribution? That's like asking "how tall is the average person?" Nonetheless, *ID* has pegged distribution's median return on net worth (ROI) at 11% for 1988, up 1% from a year earlier. This means half of all distributors participating in the *Survey* enjoyed a ROI above 11%, and the other half below. In addition, profitability varied widely depending on product line, geography and sales size (see chart).

In comparing general line houses with specialty distributors and combination houses (those selling to non-industrial markets), the latter group appeared most profitable with a 12% ROI. Specialty distributors managed to outperform the overall market with 11.5%, and generalists pulled the average down with only 10%. Keeping in mind that these figures are medians, they probably represent a performance that is higher than the "average" supply house. What's most important, however, is its trend line.

FINANCIAL SUMMARY *

(dollars in thousands)

	1987	1988
Net sales	\$1,930	\$2,100
Cost of goods sold (73% of net sales)	1,409	1,533
Gross margin	521	567
Selling expenses (23% of net sales)	444	483
Net profit (before tax, 4%)	77	84
Return on investment (% of net worth)	10	11

*Figures used are medians (see p. 43)

Source: Industrial Distribution

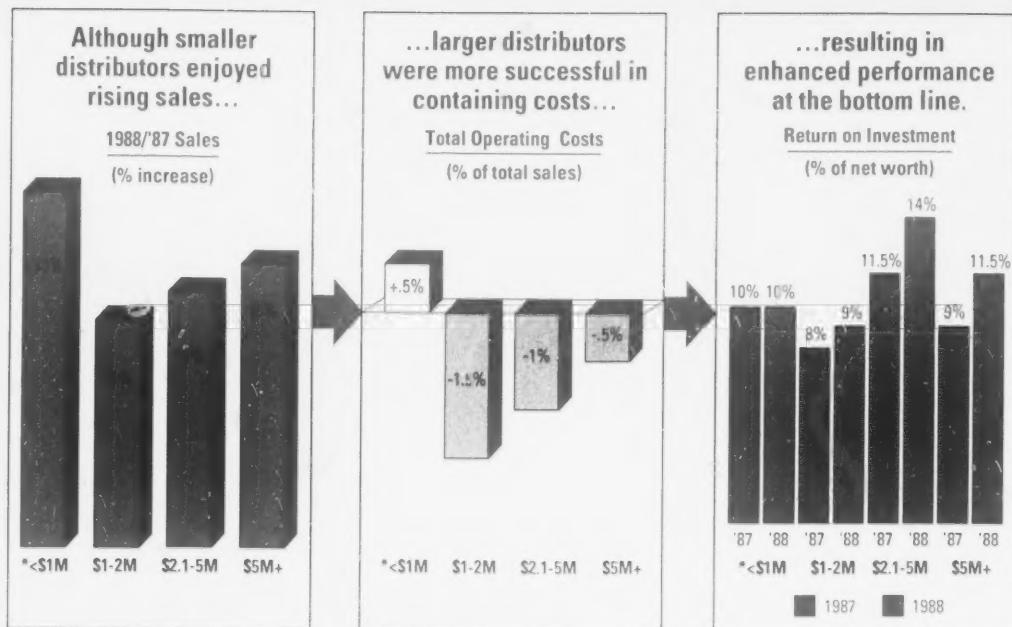
On rising sales of 8.8% in 1988, distribution's cost of goods sold remained at 73% of total sales, while gross profit (27%), total operating expenses (23%), and net profit before tax (4%), were all unchanged from a year earlier. Based on these returns, *ID* estimates that the "typical" *Survey* respondent increased gross margins from

\$521,000 in 1987 to \$567,000 in 1988 (see box). Because net profit before tax was unchanged at 4% from 1987 to 1988 and ROI increased from 10 to 11%, the data suggests that distributors used their assets more effectively during 1988 to improve overall profits.

Another assumption to make is that asset turnover may have improved in 1988 as well as the industry's financial leverage. By reducing such liabilities as bad debt and interest payments, a company can still improve ROI even if gross margins as a percent of total sales does not increase.

Interestingly, while distributors with sales below \$1 million increased their sales an extraordinary 25%, improvement to ROI remained elusive, stalling at 10%, perhaps as a result of accelerated borrowing to build inventories. On the other hand, because distributors with higher sales managed to decrease their total operating costs (as a percent of sales), ROI improved dramatically.

IS BIGGER REALLY BETTER?



*Sales dollars in millions

Source: Industrial Distribution

What worries industrial distributors?

Mergers and acquisitions are not likely to abate any time soon because of efficiencies in scale and perceptions of future profits. During 1987, one distributor in three said it was approached with an acquisition offer. In 1988, that figure climbed to 37%, with general liners being approached the most (41%), followed by combination houses (36%) and specialty distributors (35%).

But is this any guarantee that the merger mania will continue? Without any promises, the answer is probably "yes." With 30% of all distributors claiming that they would welcome an acquisition offer, and 25% of companies with sales of \$5 million-plus "actively seeking" another distributor, the acquisition chemistry appears to be percolating nicely.

Behind this urge to merge seems to be the growing expectation among

many industrial supply houses, that profit margins are likely to narrow in the future. When asked what was ahead for distribution in the coming 5 years, 63% of all distributors predict that profits will be more difficult to achieve. For example, while 40% of general liners "would welcome" an acquisition offer, half believe that margins will get tougher in years ahead.

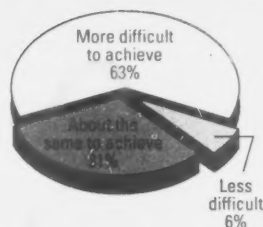
There is also an apparent relationship between a distributor's sales size, its view of profits, and its interest in acquiring other businesses (see chart). Although 36% of distributors with fewer than \$1 million in sales are interested in being acquired, 54% think margins will be more difficult down the road, and only 22% were subsequently approached with a buyout.

Conversely, distributors with \$5+ million in sales view distribution

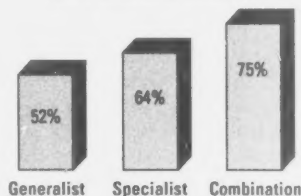
with a more pessimistic eye, but not so dour as to get out of the business. Regardless that 76% of this group believes that margins will become more difficult to achieve, 25% are looking for an acquisition, and a similar number would welcome an offer. Why? As much as the larger distributor is bothered by future profits, the potential relationship between size and profitability is clearly understood. Therefore, the picture that takes shape looks like this:

The smaller the distributor, its likelihood of being approached in an acquisition diminishes, and thus its chances of being acquired. The larger the distributor, just the opposite is true. Therefore, based on these two facts, one can only conclude that large distributors will increasingly be approached, and subsequently acquired, by other large distributors.

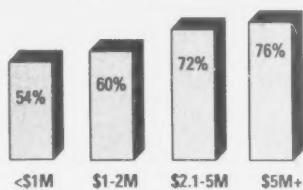
DURING THE NEXT 5 YEARS, PROFIT MARGINS WILL BECOME...



By distributor type (more difficult to achieve)



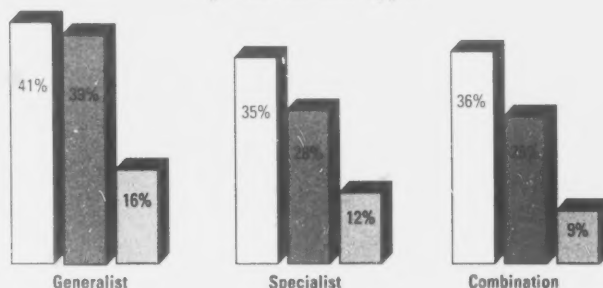
By sales size (dollars in millions)



Source: Industrial Distribution

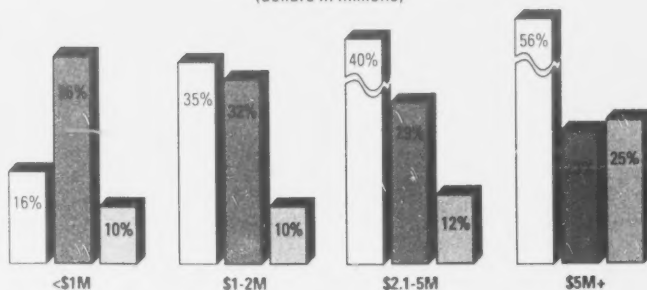
ACQUISITION ACTIVITY IN 1988

By distributor type



☐ Approached with an acquisition offer
☐ Would welcome an acquisition offer
☐ Actively seeking an acquisition

By distributor sales (dollars in millions)



Source: Industrial Distribution

PERSONNEL

Payroll costs climb with sales

When sales for industrial distributors begin to rise, does that mean a hiring binge is under foot? Wisely, the answer is no. Although national sales increased nearly 9% in 1988, overall employment figures remained unchanged, which undoubtedly helped the industry's profits.

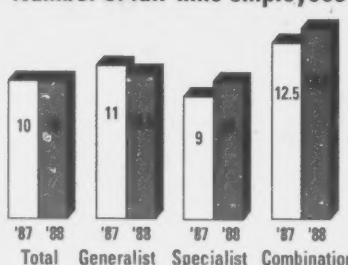
General liners, in particular, seemed to have learned this lesson well.

In 1988, generalists increased their sales over 1987 by 4%, while boosting their number of full-time employees from 10.5 to 11. As a result, sales per employee dropped, and ROI fell accordingly. Last year,

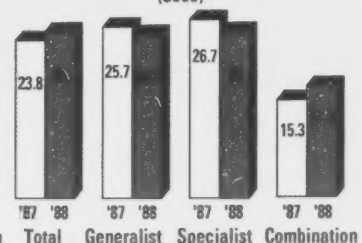
on rising sales of nearly 18%, generalists worked harder by trimming payroll thereby boosting sales per employee from \$140,000 to \$173,000. The happy result was lower operating expenses and a return on investment rising from 9.5 to 10% for the first time in years.

PERSONNEL: PAYROLL COSTS CLIMB WITH SALES

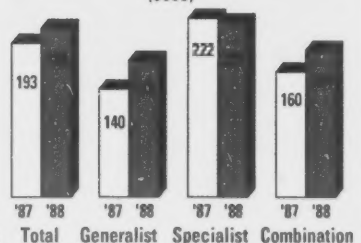
Number of full-time employees



Payroll per employee (\$000)



Sales per employee (\$000)



Source: Industrial Distribution

OPERATING COSTS

Still stuck in high gear

Distributors held operating expenses in place last year, but there is still plenty of room for improvement. Because industrial distribution is such a low margin business, any profit to be squeezed will come from lowering either warehousing costs, payroll, EDP or even insurance. According to INDUSTRIAL DISTRIBUTION's estimates, on an annualized basis, many distributors don't see a profit until the final 5 weeks

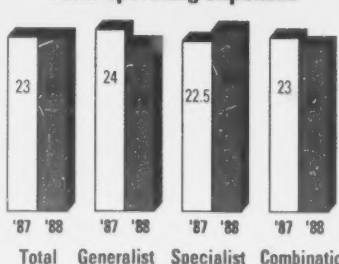
of a year. As a result, all aspects of a distributor's business must be run cost effectively; there is far too little room for excess.

In 1987 and 1988, operating expenses remained at 23% of total sales. Distributors can be commended for this performance in light of the inflationary effects of a 3.2% increase in the consumer price index for goods and services. One surprise in this year's *Survey* was the mar-

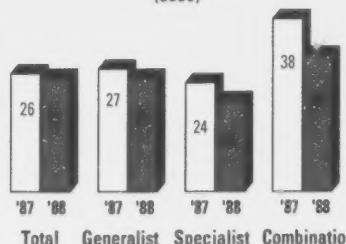
ginal reduction in overall insurance costs from \$26,000 down to \$25,000. In addition, product liability insurance also dropped from \$6,000 yearly to about \$5,000, a rather substantial and surprising decline of nearly 17%. On the other hand, EDP costs rose by 18% to \$26,000 per year, most of which is attributable to slightly higher salary and equipment costs. (See "Computers" on p.41 for a summary.)

OPERATING COSTS

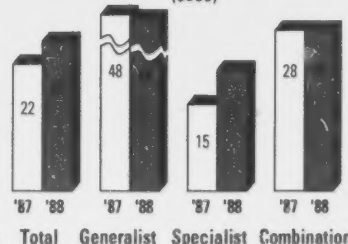
Total operating expenses



Total insurance costs (\$000)



Total EDP costs* (\$000)



*Includes salaries, equipment, materials & software

Source: Industrial Distribution

INVENTORY & RECEIVABLES

Getting the bills paid on time

When it comes to choosing a method for determining inventory value, distributors are about evenly split between LIFO (last-in-first-out) and FIFO (first-in-first-out). Either way, distributors reacted to increased sales during 1988 by stocking-up, but by no means went overboard. Using the LIFO Value method, inventories climbed a modest 1.6% while LIFO Reserves moved similarly. This is a good indication that distributors have learned to manage their inventories better, perhaps as a result of computers (see p.41).

Unfortunately, the success in managing the warehouse was not

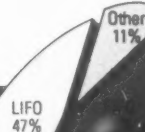
The larger the business, the larger the open receivables.

matched in the accounts receivable department. The average number of days it takes an industrial distributor to collect payment has remained at about 42 days for the past 3 years. With the prime rate averaging over 9% for 1988, distributors are effectively discounting every invoice mailed by a full percent. In keeping with previous *Survey* results, general liners continued to have an easier time closing accounts than specialists, although combination houses fared better than both.

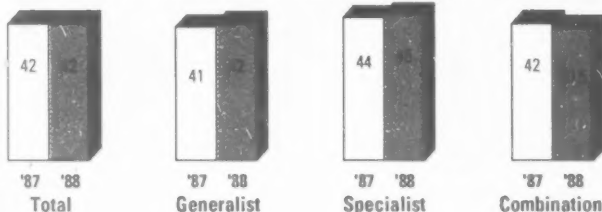
On the receivables front, distributors lost some ground. With rising sales of 8.8% industry-wide, one might reasonably assume a corresponding increase in open receivables. However, the dollar value between 1987 and 1988 increased 13% from \$201,000 to \$227,000. Only generalists managed to contain this expense (-3.2%), while specialists watched receivables rise 18% and combination houses by 6.9%.

When reviewing receivables by company size, naturally enough, the larger the business, the larger the receivables. Distributors with sales of under \$1 million watched receivables increase about 12%, as did distributors with sales between \$2.1 and \$5 million. On the high side, distributors in the \$1 to \$2 million and the \$5+ million categories, each saw receivables climb 20%.

BY WHAT METHOD DO YOU VALUE YOUR INVENTORY?



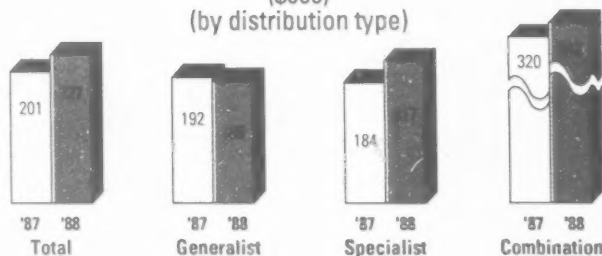
Collections (receivables outstanding in days)



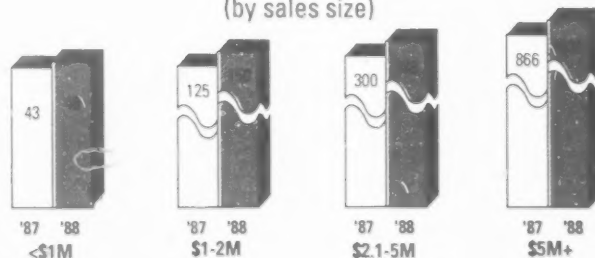
Average monthly inventory value



Receivables (\$000) (by distribution type)



Receivables (by sales size)



Source: Industrial Distribution

WAREHOUSING

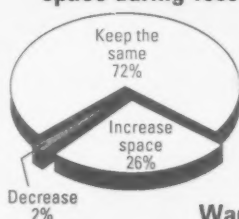
Increasing sales by the foot

By and large, distributors feel that their companies are operating a sufficient amount of warehouse space, with only 26% indicating plans to increase capacity this year. Across the board, however, the average amount of warehouse space either owned, rented or leased was increased to 7,500 sq ft. From a statistical standpoint, only generalists added an average of 400 sq ft, or roughly 5%. Both specialists and combination houses appear content with their present accommodations.

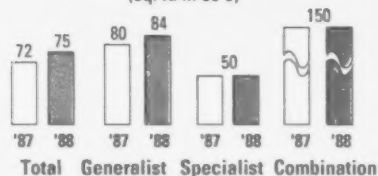
When measuring warehouse space against annual sales, all categories of distributors improved their efficiencies. The most dramatic increase was registered by combination houses (+25%), followed by generalists (+12%), and specialists (8.8%). The *Survey* also revealed that generalists operate an average of 2 stocking locations, while specialists have 3, and combination houses 3.5.

WAREHOUSING

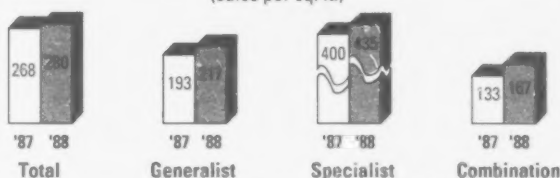
Plan to increase warehouse space during 1989



Total warehouse space (sq. ft. in 00's)



Warehouse space vs. sales (sales per sq. ft.)



Source: Industrial Distribution

COMPUTERS

EDP costs rise, but so do profits

With nearly seven distributors in when computerized, there are significant differences between those who are willing to invest in the technology, and those who are not. Among distributor types, computerization is equally prevalent among generalists, specialists and combination houses. However, the relationship between distributor sales size and computerization is dramatic.

While 38% of supply houses with sales below \$1 million have computers installed, 99% of those with sales in excess of \$5 million are similarly equipped. And how are these computers being utilized? For one thing, nearly 75% have linked their

branches together "on-time, real time," meaning that multiple branches are continuously aware of what another branch has on its shelves. However, only 8% of distributors have implemented bar coding, 3% for internal inventory purposes, and 5% for shipments.

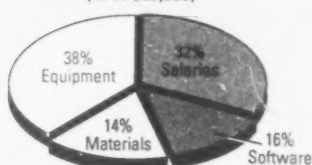
But with EDP costs rising 20% in 1988 to \$26,000, is the investment really worth it? If one looks solely at the ROI last year for computerized versus non-computerized businesses, the answer was no; one year earlier the answer was yes. Why the inconsistency? While the data can only compare profits for those with and without computers, it cannot

dissect the relationship between computerization, sales size, and profitability.

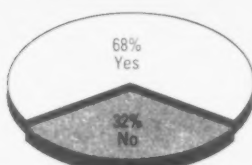
What we do know, however, is that distributors with higher sales are far more computerized than smaller businesses, and that larger supply houses are generally more profitable. Therefore, one can comfortably say that computerized distributors outperform those who are not. Further, given the distributor's need to add more profits in an ever-competitive business, the industrial distributor who invests wisely in automation may one day find himself on the winning side of a merger or acquisition.

COMPUTERS

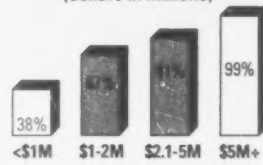
EDP costs (% of \$26,000)



Is your company computerized?



Computerization by sales (dollars in millions)



Source: Industrial Distribution

Important Facts About the Survey

Methodology

A 4-pg. questionnaire was mailed to nearly 10,000 of *ID's* readers at headquarter locations in March of this year. The *Survey* was delivered to general line distributors (those who indicate that no one product category contributes 50% or more to total sales); specialists (50% or more of total sales comes from one major product category) and; combination houses (distributors selling product to industrial and non-industrial markets such as the auto aftermarket, wholesale plumbing, heating and electric.)

A total of 434 responses were received from throughout the U.S., including Alaska and Hawaii. None were mailed to Canada or Puerto Rico. Statistical assistance was provided by Cahners Research, which has put the *Survey's* margin of error at $\pm 5\%$.

Medians & averages

Unless otherwise noted, all percentages expressed in this report are medians which, in their simplest form, define the midpoint in a statistical range. In other words, half of any group will be larger than the median, and half will be smaller than the median. The reason for using a median as opposed to an average is that medians are more representative of a group and are less distorted by extremes.

When comparing your company's performance with those of the *Survey's* respondents, a distributor should be concerned with how often his or her business is below or above a median. Continuously operating below the midpoint on certain key financial measures could signal underperformance against the industry norm. The chart below should help to make such a determination.

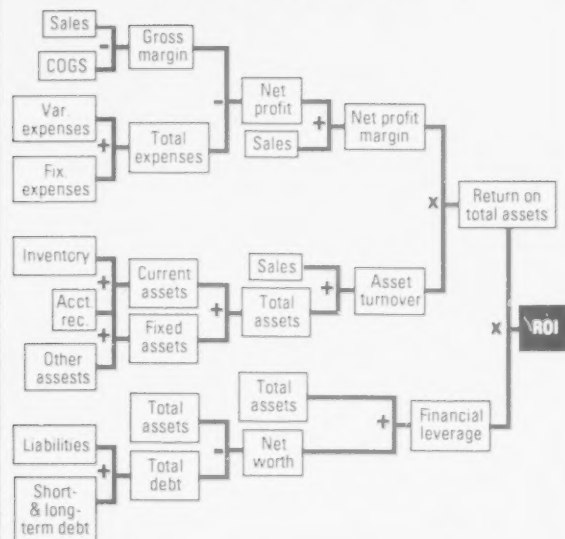
How to order the Survey

Although every effort has been made to provide *ID's* readers with the *Survey's* most important findings, only a small fraction of the total information can be provided in magazine format. In fact, the *43rd Annual Survey of Distributor Operations* is actually a report containing about 300 pages of original statistics on general line, specialty and combination distributors.

Comparisons of distributor performance by type of firm, annual sales size and five geographic regions are included. The *Survey* is the most trusted and complete reference of its kind in the industry. A single copy is \$195 prepaid, \$250 if billed. Contact: Diane Mercurio, *Industrial Distribution*, 275 Washington St., Newton, MA 01258, 617-558-4346. Customized reports are also available.

RATE YOUR COMPANY'S PERFORMANCE

How to calculate ROI



Comparing ledger sheets

	Generalist	Specialist	Comb. House	Your figures
Total sales (\$ millions)	1.8	2.2	2.5	
*COGS	73%	72%	72%	
*Gross profit	27	28	28	
*Total operating expenses	23	24	22	
*Net profit before tax	4	4	6	
*Net profit after tax	3	3	2	
ROI	11%	11.5%	12%	
No. of employees	10.5	10	13.5	
Sales per employee (\$ thousands)	171	220	185	
*% of total sales				

Source: Industrial Distribution

Are you in need of improving your company's bottom line? See *ID's* May 1988 issue: *ROI—Buy wise, sell smart*. If you would like a copy of that article, use Circle No. 560.

BUSINESS REPORT

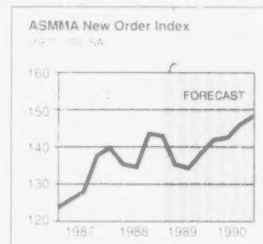
BY KRIS BLEDEWSKI

Fluid Power Sales Surge

Both pneumatics and hydraulics strong

Both orders and shipments of hydraulic and pneumatic fluid power skyrocketed in the first quarter of this year. Unlike the export-led boom of 1988, this upswing is domestically based. While demand should slow in the second half of 1989, business should be up at least 5% this year.

First quarter shipments of pneumatics were 12.9% above the comparative period a year ago, while hydraulics shot up 14.8%. Both industrial and mobile hydraulics grew at roughly the same rate of around 15%. The business cycle peak for fluid power, measured by the highest growth rate, occurred in the last months of 1988. While pneumatics should weaken rather quickly,



Data source: ASMMA
Forecast source: Capgem & Associates



Data source: I.D.A.
Forecast source: Capgem & Associates

falling to an average annual growth rate of 12.1% in 1989, hydraulics are expected to stay strong through the second half and finish the year with an annual growth rate of 20.9%.

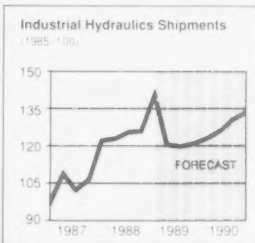
What is driving this new miniboom is a continuing fast pace of business investment. Fluid power, like machine tools, is a major component in the

production of capital goods. In spite of the slowing economy, investment in durable goods is still strong. On the one side, business optimism is high, on the other, companies report sizable profits. Both of these factors stimulate additions to capacity.

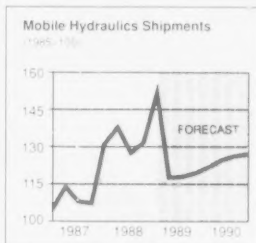
Prices of fluid power equipment have been rising much slower than the overall producer inflation

for several years. This will come to an end soon. From an annual rate of 2.9% in 1988, inflation for fluid power equipment will soar to 5.6% this year and 5.0% in 1990. Unit labor costs will contribute only marginally to this movement, while sharply higher prices for intermediate materials like forgings, castings, and tools, as well as raw materials like steel, are bound to have a much larger impact.

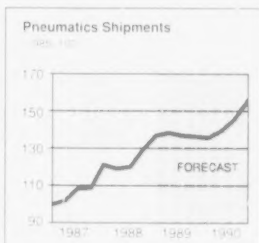
Some of the inflationary pressure is also due to capacity constraints. Leadtimes for hydraulic cylinders for example, stretched from about 4.7 weeks at the end of 1987 to about 5.5 weeks in the third quarter of 1988 and over 6 weeks by April of this year. As the backlog abates and the overall economy slows later this year, lead times will shorten to just over 5 weeks by year's end. □



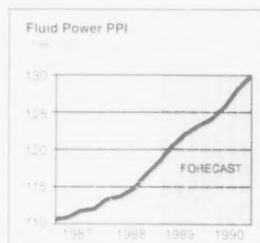
Data source: NFPA
Forecast source: Capgem & Associates



Data source: NFPA
Forecast source: Capgem & Associates



Data source: NFPA
Forecast source: Capgem & Associates



Data source: Bureau of Economic Analysis
Forecast source: Capgem & Associates

	SALES			RECEIVABLES		INVENTORY	
	Apr. 1989	Mar. 1989	Apr. '89 vs Mar. '88 % change	Apr. 1989 days	Apr. 1989 % increase	Apr. 1989 % decrease	
(1977=100)							
TOTAL	207.1	166.7	24.2	41.3	4.8	3.2	
EAST	184.3	168.0	9.7	46.1	3.9	3.6	
SOUTH	283.7	203.9	39.1	39.9	5.0	5.0	
CENTRAL	172.7	147.7	17.9	42.0	5.2	3.0	
WEST	241.4	222.6	8.3	36.0	2.0	1.7	

SOURCE: Industrial Distribution Assn.

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SUPPLY OUTLOOK

BY KRIS BLEDOWSKI

Price rises accelerate

But fears of hyperinflation are premature

As recently as three years ago producer inflation was running at one to two percent per year in most finished goods categories. The aggregate finished goods producer price index (PPI) even fell 1.4% in 1986. This non-inflationary growth period appears to be over. The PPI for finished goods has shot up to about 5% in the first months of 1989 and it should stay at that level till the end of the year. At the same time, the economy's brisk growth has slowed down. The noninflationary expansion of 1985-1988 was due to rigid monetary policy of the Fed (strict control of the money supply)

and low energy prices. At the same time, expectations about future price increases (which can be inflation stimulants themselves) were also low.

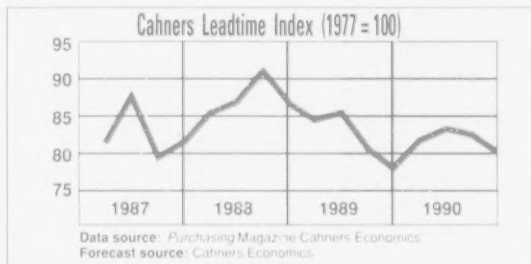
The current runup of inflation is due to tight capacity utilization in some process industries and

higher raw materials prices, primarily oil. The PPI for power transmission equipment, for example, rose from an annual rate of 2.2% in 1986 to 4.4% by April of this year. Prices for this category of equipment will be up by over 5% by the end of the

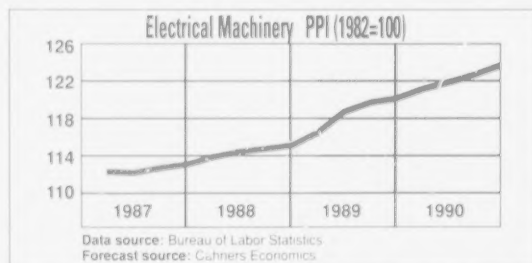
year. Likewise, prices for material handling equipment shot up from 0.7% in 1986 to 3.6% in April, while inflation for metalworking machinery advanced from 1.8% to 3.7%, respectively.

Is the inflation rate likely to soar out of control? Probably not. The Fed is holding a tight grip on the money supply and is not afraid to raise interest rates to choke off excess demand. The economy itself is slowing, making the job so much easier. Finally, there is no evidence of escalating wage pressures which would push costs up.

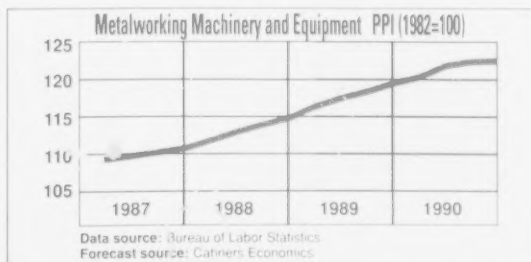
The producer inflation will not disappear soon nor will it quickly fall to zero. But the fears of a hyperinflation are not warranted. We forecast producer prices to rise 4.7% this year and 3.7% in 1990. □



PPI for finished goods will slow its recent rise and finish this year at 4.7% above last year's level.



Prices of electrical machinery have been flat since 1986 due to new, cost-saving technologies and import competition.



Inflation for metalworking machinery will accelerate to 4.0% this year and 3.2% in 1990.



We forecast prices of industrial material handling equipment to climb 4.0%, both in 1989 and 1990.

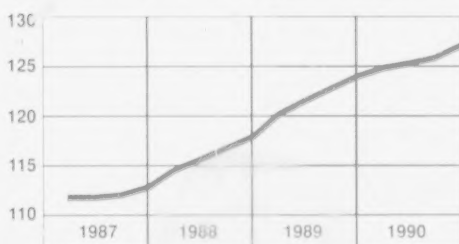
SUPPLY OUTLOOK

Intermediate Materials Prices Moderate

After advancing about 0.8% a month on average during the first quarter of 1989, the intermediate goods price index moved up 0.4% in April. Prices for intermediate goods other than foods and energy showed no change following many months of steadily rising prices, and the foods and feeds index turned down; the energy goods index, however, climbed even more than in other recent months.

There was a sharp reversal in the index for durable manufacturing materials, which went down 1.3%, as opposed to advances of at least 0.9% in 5 of the 6 preceding months. This is yet another indication that inflation is not rampant.

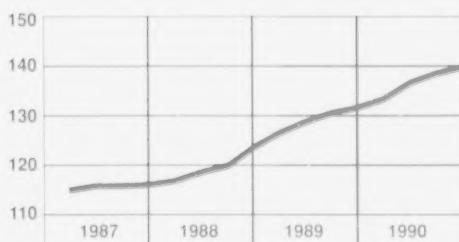
Mechanical Power Transmission Equipment PPI (1982=100)



Data source: Bureau of Labor Statistics
Forecast source: Cahners Economics

After several years at an inflation rate under 3%, prices for power transmission equipment will grow over 5% in 1989.

Paper Industries Machinery PPI (1982=100)



Data source: Bureau of Labor Statistics
Forecast source: Cahners Economics

Paper industry machinery will register an inflation rate of over 8% this year as demand outstrips supply in this booming process industry.

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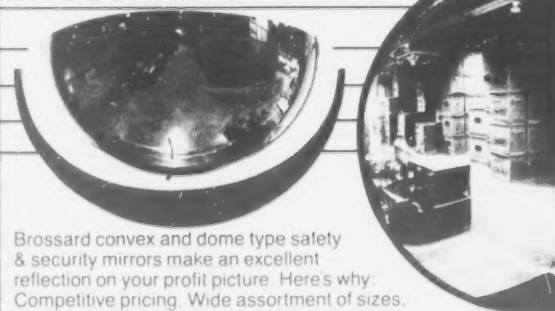
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